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In the Supreme Court of the United States

OCTOBER TERM, 1991

NEWARK MORNING LEDGER CO.,
AS SUCCESSOR TO THE HERALD COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether the purchaser of a newspaper business may treat the future revenues that it anticipates receiving from the continuing patronage of existing customers as an "intangible asset" that is depreciable under Section 167 of the Internal Revenue Code, 26 U.S.C. 167.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-30a) is reported at 945 F.2d 555. The opinion of the district court (Pet. App. 31a-51a) is reported at 734 F.Supp. 176.

JURISDICTION

The judgment of the court of appeals was entered on September 12, 1991. A petition for rehearing with suggestion for rehearing en banc was denied on October 15, 1991 (Pet. App. 52a-53a). The petition for a writ of certiorari was filed on January 13, 1992. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1976, petitioner's predecessor, the Herald Company, purchased all the stock of Booth Newspapers, Inc. Booth was the publisher of eight newspapers distributed in various Michigan communities. In 1977, Herald liquidated Booth and received all of its assets, including the eight newspaper operations. At the time of Booth's liquidation, these eight newspapers collectively had 460,000 regular subscribers.[1] Herald continued publication of the newspapers under their former banners after Booth was liquidated (Pet. 3a-4a, 34a-35a).

Following the liquidation of Booth, under the provisions of what was then Section 334(b)(2) of the Internal Revenue Code, Herald was required to allocate its basis in the Booth stock (approximately $328 million) among the assets that it received from Booth's liquidation.[2] In making this allocation, Herald was required to assign basis first to the cash, cash equivalents and marketable securities that it received from Booth, then to Booth's tangible and intangible assets (at their fair market values), with the remainder to be allocated to "goodwill" (Pet. App. 36a). See Treas. Reg. § 1.334-1(c)(4); *R.M. Smith, Inc.* v. *Commissioner*, 591 F.2d 248 (3d Cir. 1979).

Herald allocated approximately $234 million of its basis in the Booth stock to cash, securities and tangible assets such as the land, buildings and equipment formerly owned by Booth (Pet. App. 36a). Herald then assigned approximately $68 million to an intangible asset that it described as "paid subscribers" (*id.* at 4a). This "intangible asset" represented simply the number of ordinary customers who, at the time of Booth's liquidation, subscribed on a daily, at-will basis to one of the Booth newspapers (*id.* at 12a). See note 1, *supra*. Herald assigned a value of $68 million to this "intangible asset" under the following rationale: (i) due to factors such as death, relocation, and the mutable nature of consumer preferences, the average person who subscribed to Booth's newspapers on the date of Booth's liquidation would be expected to continue to purchase those newspapers for only a limited number of years, which Herald's experts estimated would vary from 14 to 23 years within the particular communities involved (*id.* at 39a); (ii) during those average lengths of continued consumer patronage, the newspapers would receive cumulative revenues from those pre-existing subscribers, net of the costs of collection, equal to the present

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[1] Petitioner repeatedly refers to these subscribers as "paid subscribers" (Pet. 4, 6, 7, 8, 9, 10, 15, 16, 26). Any connotation that these subscribers had "paid" for their subscriptions in advance is incorrect. To the contrary, these were merely daily, at-will subscriptions subject to cancellation without notice or obligation (Pet. App. 12a). Petitioner had no contractual or other legal rights to insist upon any future performance, or to demand any future custom, from any of its so-called "paid subscribers" (*ibid.*). Because the term "paid subscribers" is misdescriptive, we have substituted the term "subscribers" for it in this brief.

[2] Section 334(b)(2), 26 U.S.C. 334(b)(2) (1976), was repealed by Congress in 1982 and replaced by the somewhat different provisions of Section 338. See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 11.46, at 11-62 (5th ed. 1987). A taxpayer may also obtain all of the assets of a target corporation simply by purchasing them directly. In that situation, the taxpayer is also required to allocate the total purchase price among the acquired assets in accordance with their fair market value. See, *e.g.*, *F. & D. Rentals, Inc.* v. *Commissioner*, 365 F.2d 34 (7th Cir. 1966); *Copperhead Coal Co.* v. *Commissioner*, 272 F.2d 45 (6th Cir. 1959).

value sum of $68 million (*id.* at 44a, 46a-47a).[3] Although these customers were free to discontinue their patronage of the newspapers at any time (see note 1, *supra*), Herald's valuation rested on the assumption that they would remain customers, and produce revenues for the newspapers, for an average of 14 to 23 years after ownership of the newspapers changed hands. After allocating $68 million of its basis in the Booth stock to the "intangible asset" of its non-contractual relationships with its existing customers, Herald allocated the balance of the purchase price that remained ($26 million) to "goodwill" (Pet. App. 4a).

2. Section 167(a) of the Internal Revenue Code authorizes, as a deduction for depreciation, "a reasonable allowance for the exhaustion, wear and tear * * * of property used in the trade or business." 26 U.S.C. 167(a). On its income tax returns for periods following the liquidation of Booth, Herald sought to deduct a depreciation allowance for the "intangible asset" it claimed existed in its relationships with its at-will customers. Herald claimed that this "asset" (valued at $68 million) represented "property used in [its] trade or business" (26 U.S.C. 167(a)) that should be depreciated on a straight-line basis over the expected life of those customers' patronage (Pet. App. 4a).

[3] In making this calculation, Herald did not reduce the subscription revenues by the costs that it would necessarily incur in producing and delivering the newspaper to its customers (Pet. App. 44a). The only costs deducted by Herald in determining the expected value of its existing relationship with its subscribers were the limited costs involved in collecting the subscription revenues (*ibid.*). The government offered evidence establishing that the cost of developing the number of subscribers claimed by the Booth newspapers was approximately $3 million (*id.* at 29a).

The Internal Revenue Service disallowed the claimed depreciation deductions. Since 1927, Treasury Regulations under Section 167 have consistently provided that "[n]o deduction for depreciation is allowable with respect to goodwill." Treas. Reg. § 1.167(a)-3.[4] In the Service's view, the so-called intangible asset of "paid subscribers" (see note 1, *supra*) represents nothing other than the expected income from future patronage of present customers, which is the "goodwill" of the business that Herald purchased from Booth. The Service therefore concluded that Herald was not entitled to a deduction under Section 167.

Herald paid the additional income taxes resulting from disallowance of its claimed deduction for depreciation of its subscribers. When Herald was acquired by and merged into petitioner, petitioner filed administrative claims for refund of the additional taxes that Herald had paid. The Internal Revenue Service did not grant the requested refunds, and petitioner brought this suit in district court (Pet. App. 4a-5a, 33a-35a).

3. Following a bench trial, the district court held in petitioner's favor, ruling that the claimed depre-

[4] Treas. Reg. § 1.167(a)-3 provides:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

ciation deductions were allowable in full (Pet. App. 31a-51a). The court acknowledged that "[g]oodwill is conclusively presumed, per se, not to be depreciable" (*id.* at 49a) and that the so-called "paid subscribers" would qualify as a depreciable asset only if they were shown to have (1) a "limited useful life" whose duration could be estimated with reasonable accuracy and (2) "an ascertainable value separate and apart from goodwill" (*ibid.*).

Without considering the threshold question whether the at-will relationship between petitioner and its subscribers was "property used in the trade or business" (26 U.S.C. 167(a)) for which a depreciation deduction *could* be claimed under Section 167, the court was satisfied that petitioner had established that these subscriber relationships had a limited useful life to the business. In reaching this conclusion, the court relied on petitioner's statistical evidence that the subscribers who existed at the time of liquidation would, over a period of years, cease to be subscribers due to death, relocation, loss of interest in the newspapers, or other causes (Pet. App. 40a-42a). Although it was not disputed that the total number of petitioner's subscribers had actually increased during the years in question (*id.* at 40a), in the court's view, it was "not relevant" that new customers replaced old ones, keeping the newspapers' circulation base intact (*ibid.*).

The district court also concluded that the subscriber relationships had an ascertainable value to the newspaper company of approximately $68 million. That figure was calculated, under the methodology applied by petitioner, by capitalizing the stream of subscription income anticipated from the 460,000

existing subscribers over the average expected duration of their future patronage (Pet. App. 42a-48a).[5]

The district court further concluded that the $68 million attributed to this continuing patronage represented an asset separate and apart from goodwill (Pet. App. 32a-33a, 45a-48a). The court acknowledged that goodwill is the non-contractual expectation that "former customers will be retained—that there will be continued patronage" (*id.* at 32a, 45a). This is often described as "the expectancy that the old customers will resort to the old place" (*ibid.*). In the court's view, however, a business enjoys goodwill only when it has "a galaxy" of anonymous customers "who may or may not return" and whose "future purchases cannot be predicted" (*id.* at 32a). The court stated that the subscribers involved in this case had value and longevity as customers that "can be measured with a fair degree of accuracy" and thus possessed "unique characteristics" separating them from "general goodwill" (*id.* at 45a). The court therefore concluded that petitioner satisfied both elements of the "two-prong test" for depreciability and upheld petitioner's refund claims (*id.* at 49a).

4. The court of appeals reversed (Pet. App. 1a-30a). The court rejected petitioner's contention that any element of a business that is shown to have a limited useful life is, for that reason alone, distinct from goodwill (*id.* at 12a & n.6). The court noted that it has long been settled that goodwill, which represents the expectancy of continued patronage from existing customers, may not be depreciated (*id.* at

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[5] In calculating the net income from subscriptions for this purpose, the only costs taken into account were the relatively nominal ones of billing and collecting the subscription fees. The major costs of publishing and distributing the newspapers were omitted (Pet. App. 44a-45a).

23a-25a). The court regarded it as implicit within the numerous decisions concerning goodwill (and explicit in some of them) that the non-contractual expectancy of future patronage may not be written off as an amortizable asset even if it has a limited useful life due to the normal consumer attrition that results from death, relocation, changing tastes, and similar commercial factors (*id.* at 25a-27a, 29a).[6] The court further noted that this conclusion has long been embedded in Treasury Regulations that Congress has not disturbed (*id.* at 28a) and expressed reluctance "to announce a sudden redefinition of a concept so fundamental to tax accounting" (*ibid.*).

The court of appeals concluded that the value that petitioner imputed to its existing subscriber relationships "inherently includes much or all of the value of the expectancy that those customers will continue their patronage" and "is quite clearly comprised largely, if not exclusively, of amounts properly attributable to goodwill" (Pet. App. 30a). Finding that petitioner therefore failed to carry the burden of establishing "a value for its so-called subscribers that

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[6] The court of appeals correctly observed that this case does not involve "contractually-based" rights (Pet. App. 11a) that properly would be amortizable under Section 167 (Pet. App. 11a-12a):

> [I]f the subscribers were contractually obligated to continue subscribing for some period of time, [petitioner] clearly would be permitted to depreciate the value of those contracts over that time period. In such an event, continued patronage would not be a mere "expectation," but a contractual right, and hence not goodwill. In the case at bar, however, all the subscribers are *terminable-at-will*. At the time of the acquisition of Booth, therefore, Herald merely expected continued patronage; it had no contractual right to demand it.

is separate and distinct from goodwill," the court disallowed petitioner's claimed depreciation deductions (*ibid.*).

The court acknowledged (Pet. App. 18a-23a) that *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987) (allowing amortization of newspaper "subscription lists"), and *Citizens & Southern Corp.* v. *Commissioner*, 91 T.C. 463 (1988), aff'd per curiam, 919 F.2d 1492 (11th Cir. 1990) (allowing amortization of a bank's "core deposits"), seemingly permit taxpayers to amortize "intangible assets" whose value is based on the expected future patronage of existing non-contractual customers. The court concluded, however, that those decisions represent "no more than a minority strand amid the phalanx of cases that have considered the definition and application of the term 'goodwill' in the context of [Treas. Reg.] § 1.167(a)-3" (Pet. App. 23a).

DISCUSSION

The court of appeals correctly held that the value attributed by petitioner to the expected future patronage of its existing non-contractual customers is nondepreciable goodwill. We agree with petitioner, however, that this case involves a recurring issue of substantial administrative importance that has given rise to inconsistent reasoning and inconsistent decisions among the circuits. We therefore do not oppose the granting of certiorari in this case.

1. The prohibition against depreciation of goodwill was first included in Treasury regulations in 1927. See T.D. 4055, VI-2 C.B. 63, amending Art. 163 of Treas. Reg. 69 (Revenue Act of 1926). It has been carried forward essentially unchanged through repeated reenactments of the revenue laws and has now "acquired the force of law" (*Cammarano* v.

United States, 358 U.S. 498, 508-511 (1959)). See *Helvering* v. *Winmill*, 305 U.S. 79, 83 (1938). The basic characteristic of goodwill is the advantage that the proprietor of a business enjoys from the likelihood that existing customers will continue their patronage. *E.g.*, *Marsh & McLennan, Inc.* v. *Commissioner*, 420 F.2d 667, 669-670 (3d Cir. 1969). Goodwill may be attributable to a business's location, its age, the superiority of its products or services and any other factor that blesses it with a favorable name and reputation, helping to attract "constant or habitual customers" (*Metropolitan Bank* v. *St. Louis Dispatch Co.*, 149 U.S. 436, 446 (1893)).

The court of appeals correctly concluded that the $68 million that petitioner assigned as the value of its subscriber relationships represents nondepreciable goodwill. The subscribers were customers of the Booth newspapers when Herald took over their publication. The $68 million reflects petitioner's estimate of the income to be realized from the continuing patronage of those subscribers. The income to be derived in the future from the continuing patronage of customers falls precisely within the core of the concept of goodwill (Pet. App. 23a-25a). The value of this income is therefore not subject to depreciation under the express terms of the agency's longstanding regulations. Treas. Reg. § 1.167(a)-3.

The court of appeals correctly rejected petitioner's argument (Pet. 22-26) that the subscribers necessarily are a "property used in the trade or business" (26 U.S.C. 167(a)) that is separate from goodwill because the subscriber relationships have determinable useful lives due to death, relocation, loss of interest, or attrition for other reasons. The same is true, and could be estimated by statistical experts,

for the customers of any establishment.[7] But the very attributes of the Booth newspapers that attracted its subscribers may well induce new customers to replace them, with the result that the circulation base of the newspapers remains largely constant or even increases, as occurred in the present case (Pet. App. 40a). This ordinary turnover among clientele is one of the standard characteristics of the concept of goodwill. The value that petitioner attaches to its subscribers is directly subsumed within that concept.

2. a. Although the cases addressing the depreciation of intangibles are largely fact-based, we agree with petitioner (Pet. 15-16) that the decision in *Donrey, Inc.* v. *United States*, 809 F.2d 534 (8th Cir. 1987), could be said to conflict with the decision in the present case.[8] In *Donrey*, the taxpayer bought a

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[7] For example, an expert could no doubt be found to conclude that some specific percentage of a particular grocery store's customers are "regular customers" who shop at that store each week and will, for some estimated average length of time, continue to do so in the future until their patronage is lost due to death, relocation or changing consumer preferences. The analysis employed by petitioner in this case thus could be used to convert the goodwill of almost any commercial establishment into a depreciable "intangible asset."

[8] Petitioner clearly errs, however, in contending (Pet. 13) that the decision in the present case conflicts with *Houston Chronicle Publishing Co.* v. *United States*, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974). As the court of appeals correctly stated in its opinion in this case (Pet. App. 17a):

> The *Houston Chronicle* did not purchase an ongoing business or even a tradename as did Morning Ledger, but rather the idle assets of the defunct *Houston Press*. Hence, there was no "expectancy that old customers would resort to the old place" because "the old place" no longer existed. The value of the customer list to the *Houston Chronicle*

newspaper business for $1.3 million. Like Herald, the taxpayer in *Donrey* "stepped into the shoes" of the former owner by continuing to publish the paper under the same name. The taxpayer sought to depreciate a written subscription list (showing the number, names and addresses of subscribers) that it obtained during the purchase of the newspaper as an "intangible asset" having a limited useful life and a value of $560,000 apart from goodwill. It calculated that figure as "the present value of the difference in advertising revenues generated by the subscription list as compared to the revenues of an equivalent paper without a subscription list." *Id.* at 536. "This value was thus characterized as being separate and apart from goodwill." *Ibid.* In affirming the jury verdict in favor of the taxpayer, the court of appeals concluded that the question whether the subscription list was an asset with a limited life that was separate from goodwill was one of fact for the jury. *Id.* at 536-537.

The issue addressed in *Donrey* is factually distinct from the issue addressed in the present case. In *Donrey*, the taxpayer made an effort to identify its written "subscription list" as an asset separate and apart from its continuing non-contractual relationship with its subscribers. The taxpayer's conceptual distinction was emphasized by the method of valuation that was employed in *Donrey*: instead of simply calculating the future *sales revenues* to be derived from the continuing patronage of its existing non-

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therefore lay solely in its potential use as a marketing tool to solicit *new* customers to a *new* business.

* * * *Houston Chronicle* presented the paradigmatic circumstances under which a taxpayer could demonstrate that a subscriber list is "separate and distinct from goodwill."

contractual subscribers (as the taxpayer did in the present case), the taxpayer in *Donrey* calculated the additional future advertising revenues that it hoped to obtain by showing its subscription list to potential advertisers. See 809 F.2d at 536.

While we disagree with the conclusion in *Donrey* that this indirect benefit of continuing patronage is distinct from the value of goodwill,[9] it is nonetheless possible to distinguish the *Donrey* decision from the present case on that basis. The court of appeals concluded in this case, however, that, while the decision in *Donrey* was "cursory" and premised on deference to jury findings of fact (Pet. App. 18a), the reasoning and conclusion of *Donrey* are "directly in conflict" (*id.* at 19a) with the present case.

b. The analysis applied by the Eleventh Circuit in *Citizens & Southern Corp.* v. *Commissioner*, 919 F.2d 1492 (1990), aff'g per curiam 91 T.C. 463 (1988), and by the Tax Court in *Colorado National Bancshares, Inc.* v. *Commissioner*, 60 T.C.M. (CCH) 771 (1990), conflicts with the decision in this case. The question in *Citizens & Southern Corp.* was whether the buyer of a bank may amortize the value of the bank's "core deposits," a term defined by the taxpayer to refer to the funds that the bank's customers had on deposit at relatively low rates of interest at the time ownership of the bank changed

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[9] As the district court stated in *General Television, Inc.* v. *United States*, 449 F. Supp. 609 (D. Minn. 1977), aff'd per curiam, 598 F.2d 1148 (8th Cir. 1979), "in the instances in which customer or subscriber lists have been determined to have an ascertainable value separate and apart from goodwill, the lists alone carried with them no expectancy of continued patronage." 449 F. Supp. at 611-612. See also *Panichi* v. *United States*, 834 F.2d 300, 301-302 (2d Cir. 1987) (customer list depreciable when not acquired as part of a going concern).

hands. Such "core deposit" funds provided a significant source of the bank's income because the bank used them to make loans at higher rates of interest. The Commissioner argued that this "core deposit" intangible represented simply the value associated by the bank with the expectation that existing customers would continue their patronage by leaving funds on deposit with the bank for a number of years. The Tax Court, however, permitted the buyer to amortize the value of its "core deposits" as a wasting asset. 91 T.C. at 505-512.[10] The Eleventh Circuit affirmed and adopted the Tax Court's opinion. 919 F.2d at 1492.

In the present case, the Third Circuit disagreed with the reasoning and result of *Citizens & Southern Corp.* and found the rationale of *AmSouth Bancorporation & Subsidiaries* v. *United States*, 681 F. Supp. 698 (N.D. Ala. 1988), to be a more "persuasive and well-articulated" (Pet. App. 27a) analysis of the depreciability of customer-related intangibles such as "core deposits" (681 F. Supp. at 720):

> For accounting purposes, a bank may be able to "identify" a customer deposit base even though it may not be separate and distinct from goodwill. To the extent that deposits remain after some contractually stipulated period, they result from "continued patronage." The mere fact that the deposits themselves are identifiable, does not make their "*value*" separate and distinct from goodwill. Other facets of bank activities such as safe deposit "expectations," loan "expectations," etc. could perhaps be similarly

[10] The Tax Court reached a similar conclusion in *Colorado Nat'l Bancshares, Inc.* v. *Commissioner*, 60 T.C.M. (CCH) 771 (1990).

> "identified" so as to phase out the concept of goodwill.

The court of appeals in the present case therefore declined to follow the reasoning of the Eleventh Circuit in *Citizens & Southern Corp.* (Pet. App. 26a-27a).

3. The question presented in this case is of considerable administrative importance and potentially affects many taxpayers (see note 7, *supra*). The long-standing prohibition against the amortization of goodwill has been the subject of a substantial volume of litigation in the past and present. The revenue stakes are often high; they exceed $10 million in this case alone. A taxpayer who purchases and continues to operate a business that is favorably positioned in its market ordinarily pays a "premium" over and above what the tangible assets of the business would be worth if bought individually. This premium associated with the going concern value or goodwill of the business is often quite large. Purchasers who have paid such substantial premiums for the goodwill of a business have often argued that customer lists, subscription lists, insurance expirations, and similar items can be carved out as property independent of goodwill, assigned a discrete value and useful life, and amortized over some specific term of years. See Pet. App. 23a-25a (citing cases).

The United States General Accounting Office reports that the Internal Revenue Service, as of 1989, had proposed more than $4 billion of adjustments in cases involving the depreciation of customer or market-based intangible assets. United States General Accounting Office, *GAO/GGD-91-88 Tax Policy Report* 4 (1991). The Internal Revenue Service advises us that additional large adjustments have been

proposed in subsequent periods for tax returns claiming depreciation deductions for customer-based intangible assets. Because the courts of appeals have employed inconsistent rationales for analysis of these deductions, resolution of this recurring conflict is needed to avoid continuing uncertainty and uneven application of the revenue laws.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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